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IN TWO SECTIONS

Section I

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IN THIS ISSUE

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EDITORIAL DEPARTMENT NOTE

The article appearing in this issue of the *Bulletin* can be better characterized as a "case history" than as a "case study." The report which makes up the body of this article was originally written in 1936; the last-in, first-out method of inventory valuation was not well known then and had not been approved for income tax purposes. Some readers may wonder why an article dealing with the normal base stock method should be published at this time when the acceptance of the last-in, first-out method for income tax methods has resulted largely in the discarding of the normal base stock method for the related method which can be used for tax purposes. Justification for the publication of an article dealing with the normal base stock method at this time will be found, we believe, in the need for the accountant to be concerned about something more than mere accounting techniques. The underlying economic influences which have produced the last-in, first-out method of inventory valuation were also responsible for the development of the normal base stock theory, and perhaps the accountant can better judge these influences and better understand the considerations involved if the presentation is not tied too closely to the practicalities of a method of inventory valuantion prescribed by the Treasury Department.

The author of this article is Robert R. Renner, who received his high school and business school education in the Phillippine Islands. He is a graduate of the University of Cincinnati, and during his college career obtained a variety of cost and accounting experience with companies in Cincinnati. For four years, Mr. Renner served as Accountant and Examiner in the office of the Hamilton County Auditor, and for a short time was Auditor of the Ohio Valley Concrete Pipe Co. Since 1935 he has been connected with Spencer Kellogg & Sons, Inc., vegetable oil manufacturers of Buffalo, N. Y., as a member of the Treasurer's special staff. During this period he served for eighteen months as Assistant to the Manager of his company's cocoanut oil mill in Manila, P. I., and lectured at evening sessions of the School of Chemistry, Ateneo College on Principles of Economics and Management Accounting. Mr. Renner's present duties involve special investigation and research and analysis of various accounting problems.

Articles published in the *Bulletin* present many different viewpoints. In publishing them the Association is not sponsoring the views expressed, but is endeavoring to provide for its members material which will be helpful and stimulating. Constructive comments are welcomed and will be published in the Forum Section of the *Bulletin*.

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OCTOBER 1, 1940

THE NORMAL BASE STOCK METHOD— A CASE HISTORY

By Robert R. Renner, Special Staff, Treasurer's Department, Spencer Kellogg & Sons, Inc., Buffalo, N. Y.

A Challenge

Let's quit pussyfooting fearfully in the darkness of tradition! Let us openly admit that we are creatures of convention; that when we present figures in balance sheets and income statements those figures are but little removed from the category of hypothesis; for after all is said and done, if the camouflage of verbiage and hoary tradition is stripped away, there stands revealed before us—naked, abashed, startling—the philosophical truth that the manner in which we (yes, we accountants) arrive at figures which narrate the results of business operations is well dominated by the rule of dogmatic tradition. Brutally viewed in the spotlight of down-to-earth realism, is it not true, for example, that the figure we say represents depreciation is a pretty hypothetical and nebulous thing? Is it not similarly true that the valuation we insist on assigning to inventory (and indirectly thereby, to cost of sales) also is largely a fiction, garmented though it be in the respectable cloak of such sanctified phrases as: "first-in, first-out," "average cost," "specific lot," "normal cost," "original cost," "historical cost," "actual cost," "market," "last-in, first-out," "normal stock basis," and others?

Why, then, should we continue to smother by ostracism the not yet courageously voiced wish of businessmen (management, if you will), that we blend into our accounting doctrines a *greater* cognizance of practical business necessities and usages, and of the economic factors incident to business? Why not be honest and admit that business men *do* nurture an inhibited desire to be freed of the shackles of responsibility for those things, especially affecting net profit (or loss), over which they have no direct control? Little wonder the occasional explosion: "Accounting principles be hanged! I know when a profit and loss statement should show a profit, and just about how much too!"

Separating Profit Due to External and Internal Influences

The man who operates a business in an industry processing a basic commodity, the prices of which are subject to sensitive and uncontrollable movements because the entire industry is ruled by economic forces swaying its collective fortunes with an irresistible hand, before which such puny beings as men must submit in acquiescence, should never be expected to shoulder the responsibility for that part of profit or loss resulting from the play of these forces upon the necessary inventory with which to operate a continuing business. Let us be willing to free him of this responsibility as it is measured by our presently exercised methods of calculating profits and losses, by molding our accounting thought and technique in concordance with the economist's point of view. This for his good, and ours too.

Let us say thusly: "With your consent, and based on your practical perspective, we shall draw up profit and loss statements in such a manner as will show you as much as possible what part of profit is attributable to external and uncontrollable economic forces, and what part is the result of your own administrative actions. Or, better still, we shall even be willing if you wish, to cast out entirely the first. However, in doing this *we must warn you that* the valuation assigned, on paper, to your inventory will represent neither what it originally cost nor what may be realizable on it at the market prices current on the day stated for balance sheet values; but we *shall* show you parenthetically in all statements in which inventory valuation appears, concurrent valuations based on realizable prices as well as on original cost average."

Having spoken thus, we accountants can then lean back as in a poker game and add: "We check it to you."

There should then be few to gainsay that business men would see in a new light and with greater appreciation the men who do their accounting for them. They might even respond with enthusiasm, "*Now* you're talking brass tacks!" With this thought, let us really get down to brass tacks.

Purpose of This Case History

Many have been the words written and spoken about inventory valuation and its ramifications. The following material, adapted

from a case history, is here offered not for the purpose of expounding or championing any particular theory or method of inventory valuation, but to contribute something additional, by way of concrete evidence, to the already existing conviction that there *is* manifest in the thinking of businessmen a desire to quarantine, at least to some extent, as a thing apart, that portion of net profit or loss arising chiefly out of the play of economic change in price in its effect on inventory which is essential to the maintenance of continuity of business operations. The theory applied and the technique used to approach the objective will rest solely upon specific circumstances in individual cases; but *these in themselves are not so important as the truth that a more liberal thinking in this direction (that accountants are willing to apply theories and devise techniques) would be collectively beneficial to those of us who are accountants, and to the profession.*

Accounting partakes of the nature of science and so should never be permitted to lapse into a stodgy, decadent thing—it, and those of the profession, should be dynamic, not static. Progress demands liberalism in thinking. The word "liberalism" has been deliberately chosen for use here, despite the risk of misinterpretation—it does not imply radicalism. Far be it from us to "be the first to cast aside the old," but let us not, on the other hand, "be the last to take up the new." Let us be liberal-thinking. Let us develop and apply accounting theory in closer harmony with the economics of business. Only in this way will the science keep pace with the progress of business. *There* lies the challenge to all accountants!

The Case of the Anonymous Company

One division of the company was engaged in the production of a primary raw commodity from a basic raw material. The magnitude of operations required the carrying of very large quantities of stocks of both raw and finished products. Both of these products were subject to economic forces in supply and demand and to price changes which, when they affected the one, were almost immediately, simultaneously and in the same degree reflected in the other. Purchases and sales were largely made on contract, most of which specified deliveries spread over an extended period of time, with the result that (because sales were

recorded in the accounts only after deliveries had been made and invoiced) net income was biased by the effect of prices existing in past periods during which contracts had been made which, moreover, generally had little relation to market conditions during the period for which accounting was being made. There existed no facility for the protection against loss or of profits arising from speculative market position forced upon the management by the necessity of carrying inventory required for production; there was no "futures" market, and sound hedging could not be practiced. As a result, from year to year net profit on this product might drop from a fantastic peak to a frightful low and vice versa. The management felt that over a period of years aggregate net profit and loss should be expected to be practically the same under any scheme of accounting, and therefore considered it desirable to have stated annual net income stabilized as much as possible through the medium of accounting technique. Accordingly, a staff accountant was assigned to conduct a study and prepare a preliminary report covering the inventory aspect of the problem in so far as it affected net profits, with a view tentatively to install a system under which the normal stock theory might be satisfactorily applied.

Following is the preliminary report submitted by the staff accountant to the chief executive of the company.

THE REPORT

January 31, 1936.

Mr. John Executive
President
Anonymous Company

In accordance with your instructions to study the feasibility of applying the normal base stock theory of inventory valuation in the accounting for our Beta product operations, my findings are presented in brief in the following pages. An elaborate thesis was not written on the subject of normal base stock valuation because the theory is not new; nor was the subject of its application to our case discussed extensively because the economic forces obtaining in the industry due to trade custom and procedure are imponderables, and presently existing accounting methods and insufficiency of data for past years relative to open contracts all presented com-

plexities unsolvable with the available data. However, the accompanying presentation of the high lights will be sufficient to give you a comprehensive basis out of which an opinion on the subject may be formed.

Outstanding among the advantages apparently to be gained in adopting the method suggested will be the *revelation and emphasis focused upon the effectiveness of procurement and marketing.* For, after having largely removed from the responsibility of the management the uncontrollable factor of price variation on normal stocks, net income will then reflect chiefly the extent to which Alpha purchasing and Beta selling activities are profitable.

According to traditional principles of accounting, the normal base stock method is unorthodox, but the practical advantages to be gained in our particular circumstances appear to be enough to offset any objections because of accounting unorthodoxy. You will be interested in the fact that throughout the extensive quantity of written material on the subject of inventory valuation, in the more recent writings of economists, engineers and businessmen, and a few accountants, there is manifest a gradual but tangible sentiment favoring (in cases where circumstances reasonably warrant) inventory valuations tending to segregate out of income those profits or losses stemming from economic forces rather than from ordinary and usual business operations.

My opinion is that although the normal base stock method (which, incidentally, is older in business usage than the "last-in, first-out" method)-is still unacceptable for income tax determination, not many more years will pass before it will find its place among those which are admissible.

A brief comment seems appropriate anent the fact that the figures presented herewith (see Exhibit A at the end of this report) show that net income in the aggregate for the entire five-year period under review would be less under the normal base stock method than under the present ones. This, however, should be a consideration to be judged more from the financial than from the accounting viewpoint. As in these exhibits, and in accordance with the theory, the price chosen at which to value normal stock is lower than either cost or market, there tends to be reflected an understatement in total value of inventory in comparison with original cost (on any one of the conventional bases) and with

market. This, therefore, is a consideration of financial policy. However, as the company seldom finds itself in the financial position in which the extent of undervaluation occasioned in the total of all inventories in all divisions of the company by the use of the normal base stock method in the Beta division becomes an important factor, it would seem that external interests would be satisfied with a statement of disclosure on methods of inventory valuation. On the balance sheet the Alpha and Beta inventories may be shown parenthetically at three valuations—as appearing in the accounts, at normal stock basis, and at realizable market basis. This would enable those interested in doing so to calculate the effect on net income, as well as asset values, by the use of the normal stock method.

In consideration of the facts outlined in the accompanying report and exhibits, I have little hesitation in suggesting that the adoption of the normal base stock method for the particular inventory items in question be considered favorably.

Very respectfully,

John Jones, Accountant
Treasurer's Staff.

Background

Derived from the figures for the five years ended July 31, 1935 are the following simple arithmetical averages (rounded to the nearest thousand) which comprise a summary of the data for the end of each four-week period. All figures are given in terms of Beta product in barrels of 400 lb. each.

	Item	*Average of the 2 Years Ended July 31, 1935*	*Average of the 5 Years Ended July 31, 1935*
(a)	Stocks on hand:		
	Alpha in Patagonia (Subsidiary) ...	30,000 Bbl.	38 000 Bbl.
	Beta " " " ...	24,000 "	26,000 "
	Total	54,000 "	64,000 "
	Beta in Utopia (Parent)	46,000 "	57,000 "
	TOTAL STOCKS ON HAND	100,000 "	121,000 "
(b)	Sold but undelivered (Open sales contracts)	84,000 Bbl.	96,000 Bbl.
(c)	Long position	55,000 "	66,000 "
(d)	Alpha purchased but unreceived (Open purchase contracts)	39,000 "	41,000 "

The net income (per books) on Beta product for these same years was:—

Year Ended July 31st	*Parent Company*	*Subsidiary Company*	*Combined*
1931	$28,000	$100,000	$128,000
1932	150,000	50,000	200,000
1933	90,000	35,000	125,000
1934	(200,000)	160,000	(40,000)
1935	(150,000)	25,000	(125,000)

Note:—Figures in parenthesis denote loss.

In considering these net income figures, it is necessary to bear in mind the accounting procedures in practice. The Parent Company purchases the entire production of Beta by the Subsidiary Company at prices set by the former. Up to 1935 pricing policy appears not to have been consistently maintained with the purpose of allowing a fairly reasonable margin over costs to the subsidiary; inasmuch as in actual practice the Parent dictates purchasing policies (raw materials (Alpha) are purchased by the Subsidiary) and exercises close control over such activities, any profit or loss resulting from purchasing operations are definitely the responsibility of the Parent Company, and it seems logical that prices at which transfers between companies are made should be set so as to allow a reasonable margin to cover manufacturing operations and earn a small profit. The Subsidiary Company costs inventory on the "first-in, first-out" basis, while the Parent Company uses the "average cost" basis, averaging beginning inventory and current year purchases.

All of the exhibits and charts presented at the end of this report are self-explanatory. Nevertheless, particular attention is called to Charts 2 and 3 which illustrate the comparison of market prices with inventory prices for Alpha (Subsidiary Company raw materials) and Beta (Parent Company raw materials). It is evident that inventory prices somewhat approached market prices at the same date. This is especially true of Alpha inventories and is principally due to the fact that the quantity on hand generally approximates one month's purchases (based on disbursements for deliveries against purchase contracts) and consequently inventory price represents practically the average of the last month's purchase cost.

In the five years reviewed, market prices of Beta moved up from 2½¢ to 9¾¢, then fell to 3¢, a swing of almost 400 per cent; the same relative swing occured in the case of Alpha prices, which moved up from $22 to $57, then down to $28. (Prices quoted are nearest even dollar per ton of Alpha and nearest ¼¢ per pound of Beta).

It is fairly reasonable to conclude that, by itself, pricing of ending inventories has not been nearly so large an influence on net income variation as have been other causes. On the other hand, inventory pricing does have a very material effect, and this may be minimized by the use of the normal stock method.

The Influence of Open Contracts

As is indicated by the figures, open contracts of sale cover very large quantities; open contracts of purchase, although not so large quantitatively in comparison, nevertheless also comprise large quantities. The effect of the prices in these open contracts is not reflected in net income until after actual physical movement of the commodities has been completed, billed and entered in the accounting records as transactions for the period; therefore, book net income will always be very much affected by the relation which inventory prices bear to the prices of the contracts on which deliveries are made.

In the normal course of business, shipments (deliveries) are made against "spot" sales, as well as against back contracts. Hence, in rising markets, deliveries of Beta out of inventory priced lower than current market will produce a profit on spot sales and, presumably, on a certain portion of back contracts; *but as soon as the entire quantity of the beginning inventory has been moved, deliveries against back contracts will be made at a loss* (because back contracts always far exceed inventory) and the greater the excess of back contracts over inventory, the greater quantity on which losses will be realized. Obviously, the opposite will hold true in falling markets.

This effect, however, will be counteracted in varying degree by the influence of open purchase contracts for Alpha. On the other hand, the influence of purchase contracts is not nearly so weighty because the quantities are not usually as great in proportion to in-

ventory as are sales contracts of Beta; furthermore, as market prices for Alpha continue to rise, contracts are defaulted and replacement purchases are necessarily made at current market, and this introduces another means of loss.

Notwithstanding these facts, it is fundamental that a consistently "long position" and an extended rise in market prices will *eventually* result in large profits regardless of quantities of old inventories, back contracts and prices of each. Conversely, a prolonged market decline will result in large losses. This was strikingly experienced in the five years under review. However, the influence of back contracts does to some extent act as a retarding force on such profits or losses. If a "balanced" inventory position is maintained at all times, i.e., market position is neither long nor short, it is a logical assumption that the theory propounded in the two immediately preceding paragraphs will hold true.

There is little doubt that back (open) contracts for both sales of Beta and purchases of Alpha have a very considerable bearing and effect on annual net income; and possibly in equal if not greater degree than is that of price variation on a normal quantity of stock. Inadequacy of available data made it an impossibility to determine the extent to which open contracts have affected net income from year to year; consequently no statistical evidence can be offered and only hypothetical conclusions based on theoretical precepts may be submitted. But an inescapable conclusion, and an important one, is that in any scheme of accounting procedure to be designed for the purpose of controlling extreme variation in net income, *the potential influence of open contracts for both purchases and sales, be they favorable or unfavorable, must be given cognizance and included.*

The Normal Base Stock Theory Briefly Outlined

Of many companies operating in industries encountering economic circumstance analogous to those present in the Beta production industry, a number have adopted the normal stock method. Each company which has done so has reported success and satisfaction in the extent to which their particular applications of the theory have approached the objectives desired.

There are a number of variations in the application of the

theory and the technique employed, but its fundamentals rest in the premise that a portion (normal stock) of the inventory partakes of the nature of a fixed asset with which it is necessary to do a continuing business, and that such portion of the entire inventory should not vary in quantity or price. The quantity selected as "normal" depends entirely upon circumstances in individual cases; the price selected is usually lower than market, and lower than lowest actual cost. The portion in excess of normal is usually valued on one of the conventional "actual cost" bases; if, due to special circumstances, there should be a deficiency, the deficiency is usually valued as current market. The combination of the values so calculated results in an aggregate value for the entire inventory.

As has been stated, the normal stock method has met with the acceptance and success in certain industries to some extent. In associating the experience, cited in various writings, of other companies using it, with our particular circumstances, there seems to be reasonable justification for the conviction that we could adopt the method, adjusted to fit our problem, with success and satisfaction.

Suggestion

If we undertake to change over, it should be done completely and applied to Parent Company as well as to Subsidiary Company inventories in the Beta division. To adopt it only in the latter company would be inadequate for our purposes and the final effect on combined net income would be unsatisfactory and without significance. This opinion is founded on the fact that of a normal stock presumed necessary to cover a normal "long line" of 40,000 barrels of Beta, only about one-half consists of Alpha inventory of the Subsidiary Company; moreover, Beta inventory of the Subsidiary is so unstable in volume (due to shipments) that to include them as part of the "normal stock" would be impractical.

In addition to these considerations is the fact, as has been fairly indicated, that the variation in combined net income is influenced in very large measure by the existence of open sales contracts of Beta on the part of the Parent Company, *and these cannot be entirely disregarded.*

To enable formation of an idea of the comparison between net income under presently existing methods of inventory valuation

with that under normal stock methods in various combinations, there are presented herewith a series of charts and exhibits, the figures for which have been developed from data for the past five years.

Exhibit A is a summary comparison of net income under different combinations of normal stock treatment. Quantities and prices selected for "normal" have been carefully based on actual experience during the past five years, as is evidenced by our book records.

Chart 1 presents a graphic comparison of Beta price trend with combined net income under four methods of inventory valuation: (1) as at present, Alpha on "first-in, first-out" and crude Beta on "average cost" of beginning inventory and current year purchases; (2) with Alpha on normal basis of 6,000 tons at $25, and Beta at "average cost"; (3) with Beta on normal basis of 20,000 barrels at $.02¼ lb. and Alpha on "first-in, first-out"; and (4) with Alpha at normal of 6,000 tons at $25, and Beta at normal of 20,000 barrels at $.02¼ lb.

The hypothetical results portrayed in these exhibits and charts should be viewed as figurative rather than conclusive. The handicap in not having complete data on open contracts has made it impossible to develop a well-rounded picture. However, they do show fairly well that the normal stock method will tend to minimize extremes in income swing, and that *partial adoption would, at the most, give but inadequate results and satisfaction.*

Favorable consideration of a plan of application outlined briefly as follows, is recommended:

Proposed Application of Normal Stock Theory to our Circumstances

A. Subsidiary Company:

(1) Set normal stock at 6,000 tons Alpha (Approximately 20,000 barrels equivalent Beta).

(2) Set price of normal stock at $25 a ton. This price is selected on the basis that since 1924 actual price was below $25 only fractionally for six months in 1929, principally due to temporary panic resulting from imposition of 75 per cent export duty by the government of Patagonia (statistics indicate that natural economic

adjustment brought price level up above $25). Moreover, a price below $25 cannot be expected to prevail for any extended period because minimum cost of agricultural production lies between $20 and $25. The latter is the lowest normal price at which Alpha will be marketed.

(3) The quantity of actual inventory in excess or deficiency of normal to be priced at that representing the average of current year purchases *including open contracts.* The inclusion of open contracts in the determination of the average purchase price gives cognizance to the influence of these contracts as it tends to affect current as well as subsequent year costs and thereby income.

(4) Calculate aggregate value of inventories (beginning and ending) accordingly and charge cost of production for total consumed raw materials (Alpha) under conventional treatment, viz., beginning inventory plus purchases less ending inventory equals cost.

B. Parent Company

(1) Set normal stock at 8,000,000 pounds crude Beta (20,000 barrels).

(2) Set price of normal stock at $.02¼ a pound.

(3) The quantity of actual inventory in excess of deficiency of normal to be priced:

(a) One-half at the average of current year purchase cost.

(b) One-half at the average price of *open sales contracts for crude Beta.*

(4) Calculate aggregate value of inventories (beginning and ending) accordingly and charge cost of production or sales for total of crude Beta used, viz., beginning inventory plus purchases less ending inventory equals cost.

This manner of valuing Parent Company inventory is different from that of the Subsidiary Company because, while the latter has open purchase contracts for Alpha, it has no open sales contracts

for Beta, the entire production of which is transferred to the Parent Company at an arbitrary pricing basis; the Parent Company, on the other hand, has no purchase contracts but has open sales contracts. It gives effect to three basic economic factors affecting net income of Parent Company arising out of inventory: (1) speculative profit or loss on normal stock portion; (2) actual profit or loss because of actual purchase cost, and (3) actual profit or loss because of realizable prices on contract commitments made in prior periods. It tends to distribute or "weight" the aggregate value of the entire inventory in relation to these three sources of inventory profits and losses.

The position that total, or part, of the inventory of either company may be considered as sold but not yet delivered is defensible. Total of open sales contracts average nearly twice the stocks of either company alone. This premise may be rationalized by the fact that, although in theory sales are made on a replacement basis (that is, as sales are made the corresponding equivalent raw material is purchased at the same time), this seldom obtains in actual practice. Not only is it impossible to replace in terms of exact quantities, and at the same prices, either sales or purchases, but it is likewise impossible to buy and sell (usually) on the same day—past studies have proved that there is a time lag of approximately three to five days between corresponding activities in the two markets (Patagonia and Utopia). Consequently, it is an untenable argument that open purchase contracts are offset by corresponding open sales contracts, or vice versa. To illustrate, assume that the the close of a year there stand open sales contracts for the equivalent of 5,000 barrels of Beta, and there stand open purchase contracts for Alpha for the equivalent of the same quantity; the mere fact that the quantities are equal is not concrete evidence that the one is the exact counterpart of the other for, as has been stated, purchases are not made simultaneously with sales in exact quantity or price. Therefore it is just as reasonable to consider that open sales contracts cover parent company stocks of Beta as that they cover subsidiary company purchase contracts of Alpha or even of physical stocks of Alpha, or Beta.

It would appear, therefore, to be a practical view to hold that open sales contracts are covered by actual stocks on hand still to be delivered, thus giving defensible grounds to the idea of pricing at

least a portion (one-half in this plan) of the physical stock in excess of normal on the basis of realizable values on sales contracts, which are tangible obligations.

The use of sales contract prices in determining an average at which to value excess over normal stock will result in anticipating profits if the average is higher than original cost. On the other hand, if the average is *lower,* losses will be provided for. But over a period of years a consistent policy will not only result in the one offsetting the other, but also will tend to reflect a profit within the period when it is made and a loss similarly.

Conclusion

The purpose behind the theory of all normal stock methods is to minimize book profit or loss arising out of price movements, in so far as they affect the part of inventory which is a minimum necessity for continuity of operations, under the hypothesis that such profit or loss is fictitious in essence. The method, in contrast to the "first-in, first-out" and the "average cost" methods, works to stabilize annual profit or loss over a long period of years by minimizing extreme profits in years of rising price and extreme losses in those of declining prices.

Because there can be no accounting technique devised to control profit or loss arising out of and attributable to administrative action in raw material purchasing and finished product marketing, the greatest value in the normal stock method is that through accounting, management is relieved of the effect of uncontrollable economic forces focused in price changes on normal stocks, and thus book net income or loss will imply chiefly the extent to which purchasing and selling activities are profitable.

If adopted, either a closing or an opening inventory will have to be revalued. In either case there will be a write-down. It would seem advisable that the adjustment be made through the surplus account under the concept that the write-down is an arbitrary item not properly chargeable to management as a part of the current year's operations.

The normal stock method is not permitted for income tax determination; consequently adjustments will have to be made each year in preparing income tax returns. This does not offer as com-

plicated a problem as may at first be thought. Other companies using the method have been able to handle the matter without much difficulty and it is felt that we could do so just as well.

Much is to be gained from the system and its adoption is suggested with the qualification that adoption be in full and in reasonable conformity with the plan outlined; to do less, using it in the Subsidiary Company only, would be like using a fork for soup.

Submitted Jan. 31, 1936.

* * * *

A Closing Thought

Much has been said and written, especially in recent years, from which it may be construed that it might be a healthy development if the accounting profession would take cognizance, in greater degree than it seems to manifest, of the economic aspects obtaining in the relationship between accounting and the business operations giving occasion to it, and of the tempering of accounting theory, principles and technique with more of the economist's viewpoint, and in the application thereof achieve a reasonable relaxation from the tenacious adherence to austere tradition. To all accountants, and business men too, the mere suggestion of the existence of such a tendency should be thought provoking. Let all turn their minds upon it in a spirit of constructive, progressive liberalism in thinking.

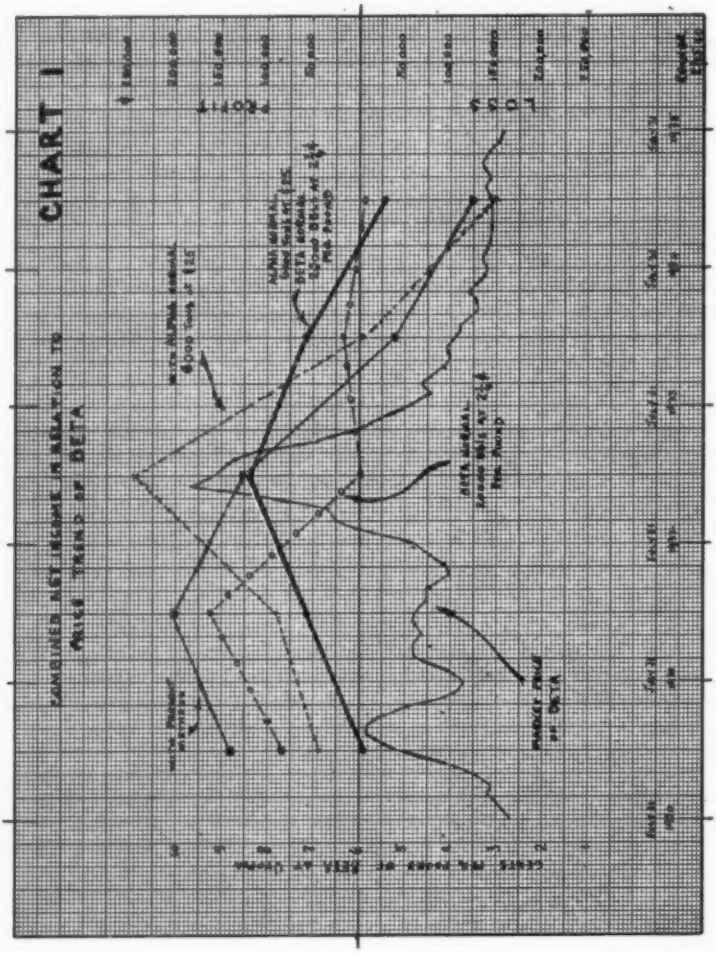
CHART I

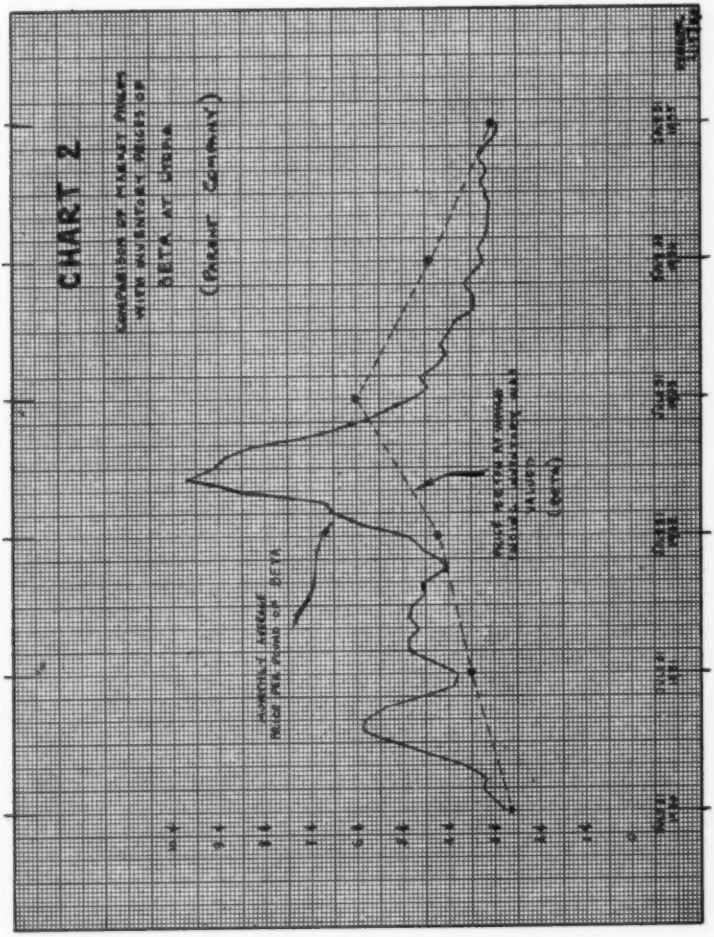
CHART 2
(Source: Germany)

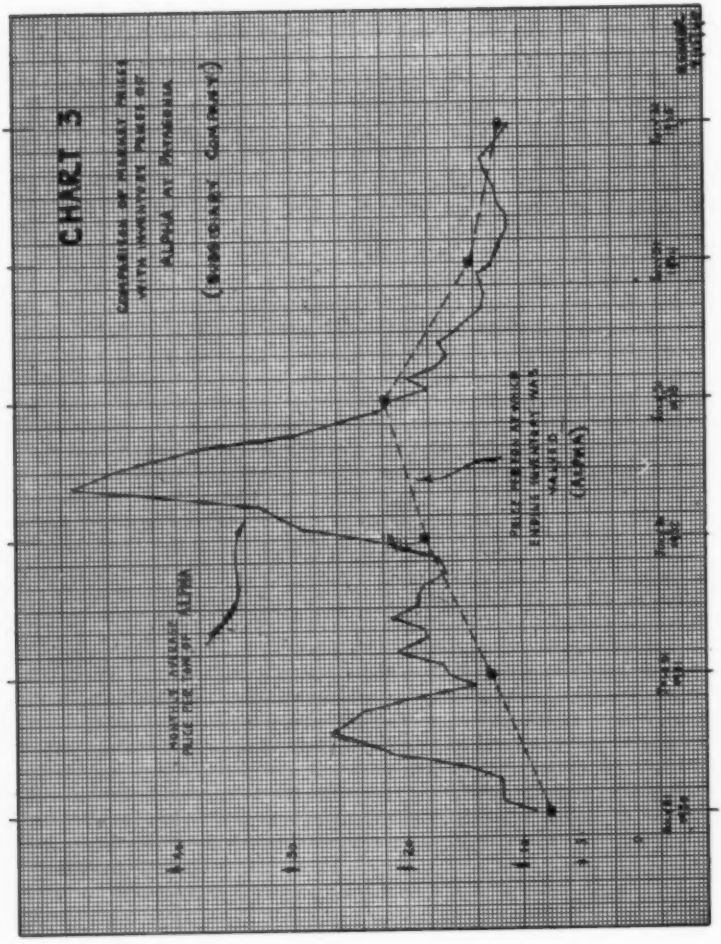
CHART 3

EXHIBIT A

COMPARISON OF COMBINED NET INCOME

ON BASIS PRESENT INVENTORY METHODS AS AGAINST
VARIOUS COMBINATIONS ON BASIS NORMAL BASE STOCK METHOD

Year Ended Jul. 31	As At Present Alpha on First-in First-out Beta on Average Cost	Beta As At Present		Alpha As At Present		Alpha Normal At 8,000 Tons $25.00		Alpha Normal At 6,000 Tons $25.00	
		Alpha Normal At		Beta Normal At		Beta Normal At		Beta Normal At	
		8,000 Tons $25.00	6,000 Tons $25.00	25,000 Bls. $.02	20,000 Bls. $.02¼	20,000 Bls. $.02¼	25,000 Bls. $.02	25,000 Bls. $.02	20,000 Bls. $.02¼
1931....	$128,000	$ 5,848	$ 42,548	$ 78,552	$ 83,252	($ 38,900)	($ 43,600)	($ 6,900)	($ 2,200)
1932....	200,000	81,394	90,034	133,710	162,510	43,904	15,104	23,744	52,544
1933....	125,000	181,911	243,231	(40,566)	1,294	58,205	16,345	77,665	119,525
1934....	(40,000)	77,769	3,249	60,899	15,679	133,448	178,668	104,148	58,928
1935....	(125,000)	(130,611)	(147,071)	19,315	(6,705)	(12,316)	13,704	(2,756)	(28,776)
Totals .	$288,000	$216,311	$231,991	$251,910	$256,030	$184,341	$180,221	$195,901	$200,021

All figures fictitious in amount.

EXHIBIT B

RECONCILIATION OF HYPOTHETICAL NET INCOME UNDER NORMAL BASE STOCK INVENTORY METHOD WITH THAT UNDER PRESENT INVENTORY METHODS

	Beta as at Present		*Alpha as at Present*		*Alpha Normal at 8,000 Tons $25.00*		*Alpha Normal at 6,000 Tons $25.00*	
	Alpha Normal at		*Beta Normal at*		*Beta Normal at*		*Beta Normal at*	
	8,000 Tons $25.00	*6,000 Tons $25.00*	*25,000 Bls. $.02*	*20,000 Bls. $.02¼*	*20,000 Bls. $.02¼*	*25,000 Bls. $.02*	*25,000 Bls. $.02*	*20,000 Bls. $.02¼*
Total Income for 5 Years Ended July 31, 1935 Under Present Inventory Methods	$288,000	$288,000	$288,000	$288,000	$288,000	$288,000	$288,000	$288,000
Changes in Beginning Inventories Decreases—(Increases)								
Parent Company	—	—	96,521	65,801	65,801	96,521	96,521	65,801
Subsidiary Company..	(45,122)	(37,622)	—	—	(45,122)	(45,122)	(37,622)	(37,622)
Changes in Ending Inventories Increases—(Decreases)								
Parent Company.....	—	—	(132,611)	(97,771)	(97,771)	(132,611)	(132,611)	(97,771)
Subsidiary Company..	(26,567)	(18,387)	—	—	(26,567)	(26,567)	(18,387)	(18,387)
Total Income for 5 Years Ended July 31, 1935 Under Normal Base Stock Methods	$216,311	$231,991	$251,910	$256,030	$184,341	$180,221	$195,901	$200,021

All figures fictitious in amount.

EXHIBIT C

Comparison of Effect on Net Income

With Alpha Inventories Valued on Normal Base Stock Method as Against First-in, First-out Method

Year Ended July 31	First-in, First-out Method			Normal Base Stock Method							(Increase) or Decrease in Cost From First-in First-out	Subsidiary		Parent	Combined Net Income	
				Normal Base Stock			Excess Over Normal Base Stock									
	Tons	Per Ton	Total Value	Tons	Per Ton	Value	Tons	Per Ton	Value	Total Value		Net Income On First-in	Net Income On Normal	Net Income	First-in Method	Normal Stock Method 6,000 Tons
1930	7,559	$19.25	$145,507	6,000	$25	$150,000	1,559	$21.25	$ 33,129	$183,129						
1931	5,173	31.90	165,081	6,000	25	150,000	(827)	39.60	(32,749)	117,251	($ 85,452)	$100,000	$ 14,548	$ 28,000	$128,000	$ 42,548
1932	8,794	48.90	430,508	6,000	25	150,000	2,794	43.92	122,712	272,712	(109,966)	50,000	(59,966)	150,000	200,000	90,034
1933	12,801	54.43	696,783	6,000	25	150,000	6,801	74.58	507,218	657,218	118,231	35,000	153,231	90,000	125,000	243,231
1934	11,917	30.81	367,138	6,000	25	150,000	5,917	37.32	220,822	370,822	43,249	160,000	203,249	(200,000)	(40,000)	3,249
1935	10,161	28.48	289,430	6,000	25	150,000	4,161	29.09	121,043	271,043	(22,071)	25,000	2,929	(150,000)	(125,000)	(147,071)

All figures fictitious in amount

EXHIBIT D

Comparison of Effect on Net Income

With Beta Inventories Valued on Normal Base Stock Method as Against Average Cost Method

Year Ended July 31	Average Cost Method			Normal Base Stock Method							(Increase) or Decrease in Cost	Net Income				
				Normal Base Stock			Excess Over Normal Base Stock					Parent		Subsid'y	Combined	
	Bls. of 400 Lbs. Each	Per Lb.	Value	Bls. of 400 Lbs. Each	Per Lb.	Value	Bls. of 400 Lbs. Each	Per Lb.	Value	Total Value		Average Cost Method	Normal Stock Method		Average Cost Method	Normal Stock Method 20,000 Bls.
1930	78,257	$.02673	$ 836,760	20,000	$.02¼	$180,000	58,257	$.02536	$590,959	$770,959						
1931	23,226	.03512	326,306	20,000	.02¼	180,000	3,226	.02771	35,757	215,757	($ 44,748)	$ 28,000	($ 16,748)	$100,000	$128,000	$ 83,252
1932	43,114	.04159	717,371	20,000	.02¼	180,000	23,114	.04211	389,332	569,332	(37,490)	150,000	112,510	50,000	200,000	162,510
1933	49,320	.05987	1,191,078	20,000	.02¼	180,000	29,320	.06309	739,333	919,333	(123,706)	90,000	(33,706)	35,000	125,000	1,294
1934	52,728	.04387	925,343	20,000	.02¼	180,000	32,728	.04043	529,277	709,277	55,679	(200,000)	(144,321)	160,000	(40,000)	15,679
1935	51,349	.03026	621,606	20,000	.02¼	180,000	31,349	.02742	343,835	523,835	118,295	(150,000)	(31,705)	25,000	(125,000)	(6,705)

All figures fictitious in amount

EXHIBIT E

COMPARISON OF EFFECT ON NET INCOME

WITH ALPHA INVENTORIES VALUED ON NORMAL BASE STOCK METHOD AS AGAINST FIRST-IN FIRST-OUT METHOD

Year Ended July 31	First-in, First-out Method			Normal Base Stock Method							(Increase) or Decrease in Cost From First-in First-out	Subsidiary		Parent	Combined Net Income	
				Normal Base Stock			Excess Over Normal Base Stock					Net Income on First-in	Net Income on Normal	Net Income	First-in Method	Normal Stock Method 8,000 Tons
	Tons	Per Ton	Total Value	Tons	Per Ton	Value	Tons	Per Ton	Value	Total Value						
1930	7,559	$19.25	$145,507	8,000	$25	$200,000	(441)	$21.25	($ 9,371)	$190,629						
1931	5,173	31.90	165,081	8,000	25	200,000	(2,827)	39.60	(111,949)	88,051	($122,152)	$100,000	($ 22,152)	$ 28,000	$128,000	$ 5,848
1932	8,794	48.90	430,508	8,000	25	200,000	794	43.92	34,872	234,872	(118,606)	50,000	(68,606)	150,000	200,000	81,394
1933	12,801	54.43	696,783	8,000	25	200,000	4,801	74.58	358,058	558,058	56,911	35,000	91,911	90,000	125,000	181,911
1934	11,917	30.81	367,138	8,000	25	200,000	3,917	37.32	146,182	346,182	117,769	160,000	277,769	(200,000)	(40,000)	77,769
1935	10,161	28.48	289,430	8,000	25	200,000	2,161	29.09	62,863	262,863	(5,611)	25,000	19,389	(150,000)	(125,000)	(130,611)

All figures fictitious in amount

EXHIBIT F

Comparison of Effect on Net Income

With Crude Beta Inventories Valued on Normal Base Stock Method as Against Average Cost Method

Year Ended July 31	Average Cost Method			Normal Base Stock Method							(Increase) or Decrease in Cost	Net Income				
				Normal Base Stock			Excess Over Normal Base Stock					Parent		Subsid'y	Combined	
	Blz. of 400 Lbs. Each	Per Lb.	Value	Blz. of 400 Lbs. Each	Per Lb.	Value	Blz. of 400 Lbs. Each	Per Lb.	Value	Total Value		Average Cost Method	Normal Stock Method		Average Cost Method	Normal Stock Method 25,000 Blz.
1930	78,257	$.02673	$ 836,760	25,000	$.02	$200,000	53,257	$.02536	$540,239	$740,239						
1931	23,226	.03512	326,306	25,000	.02	200,000	(1,774)	.02771	(19,663)	180,337	($ 49,448)	$ 28,000	($21,448)	$100,000	$128,000	$ 78,552
1932	43,114	.04159	717,371	25,000	.02	200,000	18,114	.04211	305,112	505,112	(66,290)	150,000	83,710	50,000	200,000	133,710
1933	49,320	.05987	1,191,078	25,000	.02	200,000	24,320	.06304	613,253	813,253	(165,566)	90,000	(75,566)	35,000	125,000	(40,566)
1934	52,728	.04387	925,343	25,000	.02	200,000	27,728	.04043	448,417	648,417	100,899	(200,000)	(99,101)	160,000	(40,000)	60,899
1935	51,349	.03026	621,606	25,000	.02	200,000	26,349	.02742	288,995	488,995	144,315	(150,000)	(5,685)	25,000	(125,000)	19,315

All figures fictitious in amount